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Long Bonds….How Long is Too Long?

Special Guest Columnist — Sheryl Smolkin, LL.B., LL.M.

When the Wall Street Journal reported in August that some bankers had begun sounding out investors about 100-year bonds, it seemed like just another symptom of the summer silly season.

Yet within hours, it was revealed that the Norfolk Virginia based railroad Norfolk Southern had reopened its one-hundred year bond originally issued in March 2005 at a yield of 5.95%. More importantly, demand was high and the re-opening raised an additional $250 million, far exceeding the minimum $100 million threshold set by the firm.

Other major companies that have issued century bonds include Coca-Cola, Federal Express, Ford Motor and Walt Disney. Life insurance companies and pension funds are touted as the target market for this product because they need to match long term liabilities with assets of a similar maturity for risk management purposes.

But Canadian experts say 100-year bonds are an anachronism that are of little interest to even pension fund sponsors who are implementing an LDI strategy.

"They have been issued primarily in the U.S. and they are a very illiquid part of the market," says Jim Gilliland, head of fixed income at Leith Wheeler. "To put it in context, Norfolk Southern was a $250 million issue and we've probably seen $40 to $50 billion of issuances this quarter. So it's a very tiny part of the market."

Towers Watson Senior Investment Consultant Zainul Ali sees 100 year bonds as being most attractive to those issuers who can lock in debt at low interest rates, but less desirable for defined benefit pension (DB) funds. "When you look at the cash flow in these (con't pg. 2)

A Quick Peek into Our Retirement?

By George M. Klar — President, Alternativ Solution Inc.

In August, I received an article dealing with demographics, life expectancy and the deflationary challenges ahead caused by the Baby-Boom generation. It said the Demographic Dividend, which links the past 35-years of rising investment and economic growth to boomers, has ended. The article foresees a decline in both the economy and asset values, particularly for homes. Worse, it claims neither individuals nor governments will cope well with this.

Today, the retirement liabilities of OECD nations far exceed the assets needed to discharge them. Measures, such as raising the retirement age or cutting benefits, simply can't solve the problem. Could existing tax incentives on home ownership be slashed? Will retiring boomers be forced to sell homes to offset any retirement shortfalls? If so, it's very unsettling.

This article arrived after my recent road-trip to a conference in B.C. where I spoke about Behavioural Finance. There, I discussed people's approach to retirement investing and their beliefs about certain asset classes. Both of these factors can impact the lifestyle of a retiree.

My journey across British Columbia began in Vancouver. Over the next 12-days, I drove over 1700 km visiting many large and small communities before reaching the conference centre in Whistler. Not surprisingly, B.C. attracts many new and soon-to-be retirees. (con't pg. 2)

Welcome Sheryl:

With this edition, we welcome Sheryl Smolkin to our publication. She recently launched her consulting business offering analysis, writing and editing services. It can be accessed via

http://www.sherylsmolkin.com/

Trained as a lawyer, Sheryl has more than 20 years of consulting experience in the pension and benefits areas.

She later became Editor-in-Chief of Employee Benefit News Canada. Most recently, she helped develop an education program for Capital Accumulation Plans at the Humber College Centre for Employee Benefits.

....Cheers, GMK

century bonds, they are longer than the cash flows you'd see in most DB plans, so right away there is a mismatch."

According to Ali, when DB plans are looking for long bonds, they are really looking for duration.

"Duration is different from term," he explains. "Duration is a mathematical concept which is a formulaic way of figuring out the price sensitivity of the bond to changes in interest rates. A 100-year bond gives you marginal duration advantage over a 30-year bond."

And in an era of unprecedented economic and technological change credit risk is an important consideration. "The U.S. railroad bonds are longer than we need (60 years is enough) and being corporate it is tough to assess credit quality over such long periods," says Tony Williams, president of PBI Actuarial Consultants Ltd.

Prepayment risk is another thing to consider, says Ali. "A lot of these issuers who are going to issue 100 year bonds are probably going to have the option to pre-pay these bonds whenever it is convenient to them, so you may very well not have this bond for 100 years. You have to decide as an investor if these risks – prepayment risk, the credit risk and term risk, are worth the premium you may get."

Alternativ Solution Inc.
130 King St. W, Ste. 1800, Toronto, ON M5X 1E3
B: (416) 567- 4464 george.klar@sympatico.ca

What is the premium for 100 year bonds over 30 year issues?

Ali says some investment dealers are saying they probably would have paid 75 basis points more for a 100-year bond than for a 30 year Norfolk Southern bond, assuming they had issued such a bond.

A University of Washington School of Business case study on Disney's century bond, dubbed the "Sleeping Beauty bonds", reports the issue was priced on July 20, 1993 to yield 0.95% (95 basis points) over the benchmark 30-year Treasury Bond, which at the time, yielding approximately 6.60%. Analysts estimated that this was 0.15% to 0.20% more than Disney would have paid had it issued the more conventional 30-year bonds.

But Disney also retained an important right to call (redeem) the bonds after 30 years at a specified price of 103.02% of face value. Thus 30 years after issuing the bonds, the company will have the best of both worlds. If prevailing interest rates are lower, they can call the bonds and replace them with a new cheaper bond issue. But if interest rates are high, the century bonds can remain outstanding and will continue to pay 7.55% for another seventy years!

The longest Canadian bond that Gilliland is aware of is a 60-year Quebec bond issued five years ago. Century bonds have not been issued in Canada to date and he believes Canadian pension funds have had little interest in the few U.S. 100-year bonds that have been marketed.

Williams agrees. "The currency factor is an additional concern for Canadian investors, so an ultra long provincial bond would be a better fit for our clients." ☐

Sheryl Smolkin is a lawyer, writer and editor in Toronto. She can be reached at sheryl@sherylsmolkin.com.

A Quick Peek into Our Retirement? (continued)

Despite high temperatures, the worst drought in years and numerous forest fires, it seems everyone was on the road. Motor homes, coaches, trailers, logging trucks, motorcycles and cars were everywhere. Licence plates proudly proclaim "Beautiful British Columbia" and for good reason — most places are spectacular. In the Okanagan valley, fruit orchards have morphed into world class vineyards. Oenophiles visiting the region will certainly be reminded of Napa Valley. Larger towns like Kelowna and Kamloops seem to be growing briskly, attracting retirees from across Canada and elsewhere.

I learned interesting facts while talking to locals. Housing prices rose sharply before 2007, fuelled mainly by Albertans ($150 oil) and Americans ($US). As oil tumbled and the loonie soared, the frenzy ended. Property values then fell, although Vancouver and Whistler seem largely unaffected. The retirees I meet say they are happy with life in B.C. but worry about their home values and wealth. Several people I met have taken up part-time work or started hobbies to generate extra income. At Okanagan Villa, retired banker Anthony Lewis said his rational for moving to B.C. and buying a vineyard (Vibrant Vine) was to get a simpler life. Its brought his family close together and, he hopes, will reward him financially.

Let's go back to housing and retirement. We all know the global housing frenzy affected everyone, not just Americans. The prevailing view back then was home ownership creates wealth to finance retirement (despite evidence to the contrary). In Behavioural Finance terms, we call this 'herding'. Deflation, if it materializes, would cause house prices to fall and shrink the equity value earmarked for retirement. Mass selling of boomer homes into such a market could be painful and even accelerate falling prices. While the deflation scenario is scary (and may prove wrong), it highlights a fact; relying on our homes to support our retirement needs is dangerous. Will some retirees need to consider part-time work, late-life entrepreneurship or paying hobbies? Yes. Is retirement a mirage? No, but let's just consider renaming it Freedom 75. ☐